Part I

Section 461.–General Rule for Taxable Year of Deduction

26 CFR 1.461-1: General rule for taxable year of deduction.
(Also § 404)

Rev. Rul. 2007-12

ISSUE

If the all events test and recurring item exception of § 461 of the Internal Revenue Code are otherwise met, may an accrual method taxpayer treat its Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) tax liability as incurred in Year 1 if the compensation to which the tax liability relates is deferred compensation that is deductible under § 404 in Year 2?

FACTS

X, a corporation, uses an accrual method of accounting and files its federal income tax returns on a calendar year basis. As of the end of Year 1, X has a fixed liability to pay compensation for services provided by X's employees during Year 1. As of the end of Year 1, all events have occurred to establish the fact of X's liability for the taxes ("payroll taxes") owed under §§ 3111 (the employer's share of FICA taxes) and 3301 (FUTA taxes) related to the compensation, and the amount of the payroll tax liability can be determined with reasonable accuracy. X properly adopted the recurring

item exception under § 1.461-5 of the Income Tax Regulations as a method of accounting with respect to the payroll taxes. X pays the payroll taxes either (1) in Year 1 or (2) before the earlier of September 15 of Year 2 or the date X files a timely (including extensions) federal income tax return for Year 1. Therefore, under § 461, the payroll taxes generally would be treated as incurred by X in Year 1. However, the compensation to which the payroll taxes relate is deferred compensation that is properly deductible under § 404 in Year 2.

LAW AND ANALYSIS

Section 404(a) provides, in relevant part, that if compensation is paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation, and is otherwise deductible under Chapter 1, the compensation is deductible pursuant to the rules, and subject to the limitations, of § 404.

Section 404(a)(5) provides, in part, that if the plan of compensation is not described in § 404(a)(1), (2), or (3), the compensation deductible under § 404 is deductible in the taxable year in which an amount attributable to the compensation is includible in the gross income of the employee participating in the plan. Furthermore, § 404(a)(5) provides that for purposes of § 404, any vacation pay that is treated as deferred compensation is deductible in the employer's taxable year that it is paid to the employee.

Section 1.404(b)-1T Q&A 2 provides, in part, that for purposes of § 404(a), a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services

creating the right to such compensation or benefits are performed. A plan, or method or arrangement shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered.

Section 461(a) provides that the amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section § 1.461-1(a)(2)(i) provides that, under an accrual method of accounting, a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability (the "all events test"). *See also* § 1.446-1(c)(1)(ii)(A).

Section 1.461-4(d)(2)(i) provides that in general, if the liability of a taxpayer arises out of the providing of services to the taxpayer by another person, economic performance occurs as the services are provided. Section 1.461-4(d)(2)(iii) provides that with respect to employee benefits which arise out of the provision of services to the taxpayer, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under § 404. Section 1.461-4(g)(6) provides generally that, if a taxpayer is liable to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed it.

Section 1.461-5(b)(1) provides a recurring item exception to the general rule of

economic performance. Under the recurring item exception, a liability is treated as incurred for a taxable year if: (i) at the end of the taxable year, all events have occurred that establish the fact of the liability and the amount can be determined with reasonable accuracy; (ii) economic performance occurs on or before the earlier of (a) the date that the taxpayer files a return (including extensions) for the taxable year, or (b) the 15th day of the 9th calendar month after the close of the taxable year; (iii) the liability is recurring in nature; and (iv) either the amount of the liability is not material or accrual of the liability in the taxable year results in better matching of the liability against the income to which it relates than would result from accrual of the liability in the taxable year in which economic performance occurs. Section 1.461-5(b)(5)(ii) provides that, in the case of a liability for taxes, the matching requirement of the recurring item exception is deemed satisfied.

Rev. Rul. 69-587, 1969-2 C.B. 108, concludes that, under the all events test of § 461, an accrual method employer generally may not deduct payroll taxes payable with respect to bonuses and vacation pay accrued but unpaid at year-end until the taxable year in which the bonuses and vacation pay are paid.

Rev. Rul. 96-51, 1996-2 C.B. 36, concludes that, under the all events test, an accrual method employer may deduct in Year 1 its otherwise deductible payroll taxes imposed on year-end wages properly accrued in Year 1 but paid in Year 2, provided the employer satisfies the requirements of the recurring item exception in § 1.461-5 with respect to those taxes. However, Rev. Rul. 96-51 does not address the application of § 404 because the year-end wages were paid before the 15th day of the 3rd calendar month after the end of Year 1.

In general, § 404 applies to compensation paid or accrued by an employer on account of any employee under a plan deferring the receipt of such compensation. An employer's liability for payroll taxes does not represent compensation paid or accrued by an employer on account of any employee. Therefore, § 404 does not control the deductibility of an employer's liability for payroll taxes, even if the payroll tax liability relates to a deferred compensation liability subject to the deduction rules of § 404. Accordingly, § 404 does not alter the timing of the accrual of X's payroll tax liability under § 461.

HOLDING

If the all events test and recurring item exception of § 461 are otherwise met, an accrual basis taxpayer may treat its payroll tax liability as incurred in Year 1, regardless of whether the compensation to which the liability relates is deferred compensation that is deductible under § 404 in Year 2.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 96-51 is amplified. Rev. Rul. 69-587 is revoked.

APPLICATION

A change in treatment of payroll tax liabilities associated with deferred compensation to comply with this revenue ruling is a change in method of accounting within the meaning of §§ 446 and 481 and the regulations issued thereunder. Accordingly, a taxpayer that wants to change its treatment of payroll taxes associated with deferred compensation to comply with this revenue ruling must obtain the consent of the Commissioner under § 446(e) and § 1.446-1(e)(2)(i).

DRAFTING INFORMATION

The principal author of this revenue ruling is Martin L. Osborne of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling contact Mr. Osborne on (202) 622-7900 (not a toll-free call).